In connection with the series F preferred stock offering, NPG, a stockholder that owned in excess of 5% of our voting securities at the time of the series F preferred stock offering, received 366,320 shares of series E preferred stock, which were redeemed for an aggregate total of $1.6 million, and parties affiliated with NPG, including Henry H. Bradley, chairman of our board of directors and of NPG, received 73,264 shares of series E preferred stock, which were redeemed for an aggregate total of $329,690. Advantage Capital Missouri Partners I, L.P., a stockholder which owned in excess of 5% of our voting securities at the time of the series F preferred stock offering, received 293,056 shares of the of the series E preferred stock, which were redeemed for an aggregate total of $1.3 million. Bradley A. Moline, our senior vice president of finance and chief financial officer, received 15,385 shares of series E preferred stock, which were redeemed for an aggregate total of $69,234. Pacific Capital, L.P., a stockholder which owned in excess of 5% of our voting securities at the time of the series F preferred stock offering, received 271,095 shares of the of the series E preferred stock, which were redeemed for

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an aggregate total of $1.2 million. Steven L. Sauder, our vice president, together with his father, Earl W. Sauder, received an aggregate of 19,048 shares of series E preferred stock, which were redeemed for an aggregate total of $85,718. KCEP I and KCEP II together received an aggregate of 210,022 shares of series E preferred stock, which were redeemed for an aggregate total of $945,099.

PURCHASERS RIGHTS AGREEMENT

Our current stockholders are parties to the purchasers rights agreement, which provides that they vote their respective shares in a manner as to elect persons specified in the agreement to serve as directors. The holders of series F preferred stock have agreed to vote their shares to elect Messrs. Greene, Navab and Clammer. The two additional designees of the holders of series F preferred stock are Messrs. Kravis and Roberts. In addition, the holders of series B preferred stock, series C preferred stock and series D preferred stock have agreed to vote their shares to elect Henry H. Bradley and Thomas R. Palmer. The holders of common stock have agreed to vote their shares for the election of David E. Scott. So long as the purchasers rights agreement is in effect, these investors will effectively control the election of our board of directors.

REGISTRATION RIGHTS

The parties to the purchasers rights agreement, subject to some conditions, have registration rights with respect to shares of common stock, including shares of common stock issuable upon conversion or redemption of shares of series F preferred stock or upon conversion of shares of series B preferred stock, series C preferred stock, or series D preferred stock. These purchasers have, subject to some conditions, demand and "piggy-back" registration rights. The purchasers rights agreement provides that each purchaser of stock is subject to lock-up restrictions in the event of a public offering of our securities.

RESTRICTIONS ON TRANSFER

Our outstanding common stock (including shares issued pursuant to options) and each series of preferred stock are subject to restrictions on transfer. Holders of common stock and each series of preferred stock that are parties to the purchasers rights agreement, subject to some exceptions, may not transfer their shares without first giving us the opportunity to purchase the shares. In addition, subject to some exceptions, the holders of common stock or any series of preferred stock that are parties to the purchasers rights agreement may not transfer their shares without first giving the other purchasers under the purchasers rights agreement the opportunity to participate in the transfer.

PRE-EMPTIVE RIGHTS

Holders of our common stock and each series of preferred stock that are parties to the purchasers rights agreement have the right to purchase a pro rata portion of any common stock or preferred stock that we propose to sell and issue, subject to some exceptions.

SIZE OF THE BOARD OF DIRECTORS

The purchasers rights agreement provides that so long as at least 6,666,667 shares of series F preferred stock remain outstanding, the holders of series F preferred stock are entitled to elect and remove directors in accordance with our restated certificate. In the event that less than 6,666,667 shares of series F preferred stock remain outstanding, but BTI Ventures L.L.C. and its affiliates, which include KKR, beneficially own at least 10% of our outstanding common stock, BTI has the right to designate the number of persons to serve as members of the board determined in accordance with a formula set forth in the purchasers rights agreement. Currently there are five BTI nominees sitting on our eleven seat board of directors.

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For so long as at least 8,532,394 shares of series B preferred stock, series C preferred stock and series D preferred stock remain outstanding, the holders of this stock, voting together as a class, are entitled to elect and remove directors pursuant to our restated certificate.

BTI DRAG-ALONG RIGHTS

Holders of common stock and each series of preferred stock that are parties to the purchasers rights agreement are required to sell their shares in the event that BTI Ventures L.L.C. or its affiliates agree to sell or transfer their shares, or to sell all or substantially all of our assets, to a third party.

BTI VETO RIGHTS

The purchasers rights agreement provides that for so long as BTI or any of its affiliates beneficially owns at least 6,666,667 shares of our common stock or series F preferred stock, the approval of at least one BTI nominee on our board will be required for our board of directors to approve and authorize any of the following: any changes in our capital structure, such as increases or decreases in the total authorized shares of our common stock and issuances of our capital stock; any payment of dividends or distributions on our capital stock; subject to limited exceptions, any reclassification, combination, split, redemption or other acquisition of any shares of our capital stock; any incurrence of indebtedness exceeding $5.0 million; any change in the size or composition of our board or any board committee or creation of any board committee; subject to limited exceptions, any affiliate transaction; any hiring or termination of a chief executive officer or other key officer; any adoption or modification of our annual budget and business plan; any amendment or modification of any material provision of our senior notes indenture, senior credit facility or any other material contract; any adoption, renewal or material modification of any material compensation or benefit plan or arrangement; any authorization of entering into a new line of business or the expansion outside of Missouri, Kansas and Texas; any consolidation, reorganization, recapitalization, merger or similar transaction; any transfer of our assets, including by pledge, in excess of $5.0 million; subject to limited exceptions, any acquisition of assets or securities for more than $5.0 million; any amendment to our certificate of incorporation or bylaws; any voting or similar arrangement regarding our capital stock; any payment, discharge or satisfaction of any material claim or liability or the commencement of a material suit; any joint venture involving material assets or the payment or receipt of more than $5.0 million; any material license, contract or agreement; or any liquidation, dissolution or winding up of our company.

OTHER TRANSACTIONS WITH AFFILIATES

VALU-LINE LOANS

As of December 31, 1997, Valu-Line of Kansas, Inc., which merged into us on February 10, 1998, had notes payable of $240,000 in the aggregate from Stephen L. Sauder and Mr. Sauder's father. Mr. Sauder was the president and principal stockholder of Valu-Line at the time the loan was made and currently owns more than 5% of our voting securities. The loans were due on demand. As of December 31, 1998, the amounts outstanding under these loans were fully repaid.

DEALINGS WITH VALU-BROADCASTING, INC.

In 1999, 1998, and 1997 we, and our predecessor, Valu-Line, provided services principally related to rent and operating costs to Valu-Broadcasting, Inc., an affiliate of Valu-Line, which is owned by Stephen L. Sauder, one of our stockholders who owned more than 5% of our voting securities at the time of the transactions, in the amounts of $29,187, $30,000 and $81,000, respectively. Valu-Line also received services principally related to advertising from Valu-Broadcasting in the amounts of $30,360, $40,000 and $41,000 in 1999, 1998 and 1997, respectively.

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SHARES ISSUANCES TO DIRECTORS

In March 2000, Mr. Jalkut, chairman of our board of directors, agreed to purchase 26,667 shares of our common stock for $200,000, and Mr. Ejabat, a member of our board of directors, agreed to purchase 66,667 shares of our common stock for $500,000.

PART IV.

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) Documents filed as part of this report

(1) Financial Statements

See "Item 8. Financial Statements and Supplementary Data" for financial statements included with this Annual Report on Form 10-K.

(2) Financial Statement Schedules

Schedule II--Consolidated Valuation and Qualifying Accounts

BIRCH TELECOM, INC.
SCHEDULE II--CONSOLIDATED VALUATION AND QUALIFYING ACCOUNTS
YEARS ENDED DECEMBER 31, 1997, 1998 AND 1999

		ADDITIONS			
	BALANCE BEGINNING OF YEAR	CHARGED TO INCOME	CHARGED TO OTHER ACCOUNTS	OTHER DEDUCTIONS	BALANCE END OF YEAR
			(IN THOUSANDS)		
1997					
Valuation allowance--deferred income tax assets	$ 0	$ 681	$ 0	$ 0	$ 681
1998					
Allowance for doubtful accounts	$ 0	$ 140	$133	$ (39)(1)	$ 234
Valuation allowance--deferred income tax assets	$ 681	$ 5,118	$ 0	$ 0	$ 5,799
1999					
Allowance for doubtful accounts	$ 234	$ 561	$125	$(464)(1)	$ 456
Valuation allowance--deferred income tax assets	$5,799	$22,942	$ 0	$ 0	$28,741

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(1) Accounts written off, net of recoveries.

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(3) Exhibits

EXHIBIT NO.	DESCRIPTION OF EXHIBIT
2.1	Agreement and plan of merger among Birch Telecom, Inc., Valu-Line Companies, Inc., Stephen L. Sauder, Paula K. Sauder, Richard L. Tidwell, Sarah J. Tidwell, Stormy Supiran and Carla S. Supiran. (incorporated by reference to Exhibit 2.1 to Birch Telecom, Inc.'s registration statement on Form S-4, as amended (SEC File No. 333-62797), originally filed September 3, 1998 (Form S-4)).
3.1	Restated certificate of incorporation of Birch Telecom, Inc. (incorporated by reference to Exhibit 3.1 to Birch Telecom Inc.'s registration statement on Form S-1 filed March 23, 2000.)
3.2	Restated bylaws of Birch Telecom, Inc. (incorporated by reference to Exhibit 3.2 to the Form S-4).
10.1	Birch Telecom, Inc. securities purchase agreement (incorporated by reference to Exhibit 10.1 to the Form S-4).
10.2	Birch Telecom, Inc. amended and restated purchasers rights agreement, dated August 5, 1999 (incorporated by reference to Exhibit 10.2 to the Form 10-Q).
10.3	Amended employment agreement dated as of October 7, 1999 between Birch Telecom, Inc. and David E. Scott. (incorporated by reference to Exhibit 10.3 to Birch Telecom Inc.'s registration statement on Form S-1 filed March 23, 2000.)
10.4	Amended employment agreement dated as of October 7, 1999 between Birch Telecom, Inc. and Gregory C. Lawhon. (incorporated by reference to Exhibit 10.4 to Birch Telecom Inc.'s registration statement on Form S-1 filed March 23, 2000.)
10.5	Amended employment agreement dated as of October 7, 1999 between Birch Telecom, Inc. and Donald H. Goldman. (incorporated by reference to Exhibit 10.5 to Birch Telecom Inc.'s registration statement on Form S-1 filed March 23, 2000.)
10.6	Amended employment agreement dated as of October 7, 1999 between Birch Telecom, Inc. and David W. Vranicar. (incorporated by reference to Exhibit 10.6 to Birch Telecom Inc.'s registration statement on Form S-1 filed March 23, 2000.)
10.7	Employment agreement dated as of February 10, 1998 between Birch Telecom, Inc. and Stephen L. Sauder (incorporated by reference to Exhibit 10.7 to the Form S-4).
10.8	General agreement between Birch Telecom, Inc. and Lucent

	Technologies Inc. (incorporated by reference to Exhibit 10.12 to the Form S-4).
10.9	Interconnection agreement under Sections 251 and 252 of the Telecommunications Act of 1996 by and between Southwestern Bell Telephone Company and Birch Telecom of Missouri, Inc. (Missouri Interconnection Agreement) (incorporated by reference to Exhibit 10.13 to the Form S-4).
10.10	Amendment No. 1 dated May 27, 1998 to Missouri interconnection agreement (incorporated by reference to Exhibit 10.10 to Birch Telecom, Inc.'s annual report on form 10-K for the fiscal year ended December 31, 1998, originally filed on March 31, 1999 (Form 10-K)).
10.11+	Software license agreement between Birch Telecom, Inc. and Saville Systems Inc. (incorporated by reference to Exhibit 10.14 to the Form S-4).
10.12	Interconnection agreement under Sections 251 and 252 of the Telecommunications Act of 1996 by and between Southwestern Bell Telephone Company and Birch Telecom of Kansas, Inc. (incorporated by reference to Exhibit 10.12 to the Form 10-K).

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EXHIBIT NO.	DESCRIPTION OF EXHIBIT
10.13	Interconnection agreement under Sections 251 and 252 of the Telecommunications Act of 1996 by and between Southwestern Bell Telephone Company and Birch Telecom of Texas Ltd., LLP. (incorporated by reference to the Exhibit 10.13 to the Form 10-K).
10.14	1998 stock option plan (incorporated by reference to Exhibit 10.14 to Birch Telecom Inc.'s annual report on Form 10-K for the fiscal year ended December 31, 1998, as amended, filed on May 7, 1999 (Form 10-K/A)).
10.15	Form of incentive stock option agreement under 1998 stock option plan (incorporated by reference to Exhibit 10.15 to the Form 10-K/A).
10.16	Form of nonstatutory stock option agreement under 1998 stock option plan (incorporated by reference to Exhibit 10.16 to the Form 10-K/A).
10.17	Lease agreement between Francor, L.L.C. and Birch Telecom, Inc. dated July 20, 1998 (incorporated by reference to Exhibit 10.17 to the Form 10-K/A).
10.18	Series D preferred stock purchase agreement, dated July 2, 1999 (incorporated by reference to Exhibit 10.18 to Birch Telecom Inc.'s quarterly report or Form 10-Q for the period ended September 30, 1999, filed November 15, 1999 (Form 10-Q)).
10.19	Series F preferred stock purchase agreement, dated July 13, 1999 (incorporated by reference to Exhibit 10.19 to the Form 10-Q).
10.20	Amended and restated credit agreement among Birch Telecom Finance, Inc., Birch Telecom, Inc., Lehman Brothers Inc.,

	Lehman Commercial Paper Inc., Bankers Trust Company and Bank of America, Inc., as agents and lenders, and the other lenders party thereto dated February 2, 2000. (incorporated by reference to Exhibit 10.20 to Birch Telecom Inc.'s registration statement on Form S-1 filed March 23, 2000.)
10.21	Amended and restated guarantee and collateral agreement, dated as of February 2, 2000, among Birch Telecom Finance, Inc., Birch Telecom, Inc. and Lehman Commercial Paper, Inc., as collateral agent. (incorporated by reference to Exhibit 10.21 to Birch Telecom Inc.'s registration statement on Form S-1 filed March 23, 2000.)
10.22	Amended employment agreement dated as of October 7, 1999 between Birch Telecom, Inc. and Bradley A. Moline. (incorporated by reference to Exhibit 10.22 to Birch Telecom Inc.'s registration statement on Form S-1 filed March 23, 2000.)
10.23	Amended employment agreement dated as of October 7, 1999 between Birch Telecom, Inc. and Jeffrey D. Shackelford. (incorporated by reference to Exhibit 10.23 to Birch Telecom Inc.'s registration statement on Form S-1 filed March 23, 2000.)
10.24	Employment agreement dated as of February 2000 between Birch Telecom, Inc. and David M. Hollingsworth. (incorporated by reference to Exhibit 10.24 to Birch Telecom Inc.'s registration statement on Form S-1 filed March 23, 2000.)
10.25	Indenture, dated as of June 23, 1998, between Birch Telecom, Inc. and Norwest Bank Minnesota, National Association, as trustee, relating to $115,000,000 aggregate principal amount of 14% senior notes due 2008 (incorporated by reference to Exhibit 4.1 to the Form S-4).
10.26	Specimen certificate of 14% senior notes due 2008 (Exchange Notes) (included in Exhibit 4.1, which is incorporated by reference to Exhibit 4.1 to the Form S-4).
10.27	Collateral pledge and security agreement, dated as of June 23, 1998 from Birch Telecom, Inc., Pledgor, to Norwest Bank Minnesota, National Association, Trustee (incorporated by reference to Exhibit 4.5 to the Form S-4).
10.28	Letter agreement dated as of March 22, 2000 between Birch Telecom, Inc. and Mory

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EXHIBIT NO.	DESCRIPTION OF EXHIBIT
	Ejabat. (incorporated by reference to Exhibit 10.28 to Birch Telecom Inc.'s registration statement on Form S-1 filed March 23, 2000.)
10.29	Letter agreement dated as of March 22, 2000 between Birch Telecom, Inc. and Richard A. Jalkut. (incorporated by reference to Exhibit 10.29 to Birch Telecom Inc.'s registration statement on Form S-1 filed March 23, 2000.)
10.30	Amendment number one dated as of March 23, 2000 to the amended and restated purchasers rights agreement. (incorporated by reference to Exhibit 10.30 to Birch Telecom

	Inc.'s registration statement on Form S-1 filed March 23, 2000.)
12.1*	Computation of Ratio of Earnings to Fixed Charges.
21.1	Subsidiaries of Birch Telecom, Inc. (incorporated by reference to Exhibit 21.1 to the Form S-4).
24.1*	Power of attorney (included on the signature page).
27.1*	Financial data schedule.

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* Filed herewith.

\+ Portions of this exhibit have been omitted pursuant to a request for confidential treatment. Such portions have been filed separately with the Commission.

(b) Reports on Form 8-K.

On March 23, 2000 we filed Form 8-K with respect to a registration statement filing with the SEC as part of a proposed initial public offering of common stock. We attached a copy of our press release issued that same day.

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SIGNATURES

PURSUANT TO THE REQUIREMENTS OF THE SECTION 13 OR 15(D) OF THE SECURITIES AND EXCHANGE ACT OF 1934, AS AMENDED, THE REGISTRANT HAS DULY CAUSED THIS REPORT TO BE SIGNED ON ITS BEHALF BY THE UNDERSIGNED, THEREUNTO DULY AUTHORIZED, IN THE CITY OF KANSAS CITY, STATE OF MISSOURI.

BIRCH TELECOM, INC.

By: /s/ DAVID E.

SCOTT

David E.

Scott

PRESIDENT AND CHIEF

EXECUTIVE OFFICER

Date: March , 2000

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints David E. Scott and Bradley A. Moline, and each of them, his attorneys-in-fact and agents, with full power of substitution and resubstitution, for him and in his name, place, and stead, in any and all capacities, to sign any and all amendments to this Report on Form 10-K, and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission granting unto such attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming that all such attorneys-in-fact and agents, or any of them or their or his substitute or substituted, may lawfully do or cause to be done by virtue hereof.

PURSUANT TO THE REQUIREMENTS OF THE SECURITIES AND EXCHANGE ACT OF 1934, THIS REPORT HAS BEEN SIGNED BELOW BY THE FOLLOWING PERSONS ON BEHALF OF THE REGISTRANT IN THE CAPACITIES AND AS OF THE DATES INDICATED.

SIGNATURE DATE	TITLE
--- March 30, 2000 DAVID E. SCOTT	President, Chief Executive Officer and Director (Principal Executive Officer)
--- Financial March 30, 2000 BRADLEY A. MOLINE	Senior Vice President of Finance and Chief Financial Officer (Principal and Accounting Officer)
--- March 30, 2000 HENRY H. BRADLEY	Director
--- March 30, 2000 ADAM H. CLAMMER	Director
--- March 30, 2000 JAMES H. GREENE, JR.	Director
--- March 30, 2000 ALEXANDER NAVAB, JR.	Director
--- March 30, 2000 THOMAS R. PALMER	Director

INDEX TO FINANCIAL STATEMENTS AND FINANCIAL STATEMENT SCHEDULE

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REPORT OF INDEPENDENT AUDITORS

THE BOARD OF DIRECTORS AND STOCKHOLDERS
BIRCH TELECOM, INC.

We have audited the accompanying consolidated balance sheets of Birch Telecom, Inc. (Birch) as of December 31, 1998 and 1999, and the related consolidated statements of operations, stockholders' equity (deficit) and cash flows for each of the three years in the period ended December 31, 1999. Our audit also included the financial statement schedule listed in the Index to Financial Statements and Financial Statement Schedule. These financial statements and schedule are the responsibility of Birch's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Birch Telecom, Inc. at December 31, 1998 and 1999, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1999, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material aspects the information set forth therein.

Ernst & Young LLP

Kansas City, Missouri
February 17, 2000, except for note 19, as to
which the date is March 23, 2000

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BIRCH TELECOM, INC.

CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 1998 AND 1999

(IN THOUSANDS, EXCEPT SHARE DATA)

	1998	1999
ASSETS		
Current assets:		

Cash and cash equivalents	$ 39,745	$ 5,053
Pledged securities	15,888	15,936
Accounts receivable, net	4,039	11,612
Inventory	916	3,735
Prepaid expenses and other	526	2,443
Total current assets	61,114	38,779
Property and equipment	26,900	70,192
Less: accumulated depreciation	747	8,080
Property and equipment, net	26,153	62,112
Pledged securities--noncurrent	21,897	7,484
Goodwill, net	16,863	19,316
Other intangibles, net	7,620	16,911
Other assets	502	2,369
Total assets	$134,149	$146,971
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities:		
Current maturities of long-term debt and capital lease obligations	$ 335	$ 1,300
Accounts payable	8,503	13,300
Accrued expenses	2,556	10,793
Total current liabilities	11,394	25,393
Senior credit facility	--	10,000
14% senior notes	114,681	114,715
Capital lease obligations, net of current maturities	778	836
Other long-term debt, net of current maturities	332	234
Series B redeemable preferred stock, 8,572,039 shares issued and outstanding in 1998 (stated at redemption and aggregate liquidation value)	14,063	--
Series F redeemable preferred stock, 13,333,334 shares issued and outstanding in 1999 (stated at redemption and aggregate liquidation value)	--	63,550
Stockholders' deficit:		
Series B preferred stock, 8,572,039 shares issued and outstanding in 1999	--	8
Series C preferred stock, 8,492,749 and 6,270,527 shares issued and outstanding	8	6
Series D preferred stock, 2,222,222 shares issued and outstanding in 1999	--	2
Common stock, $.001 par value, 80,000,000 shares authorized, 5,016,889 and 4,687,767 shares issued and outstanding	5	5
Warrants	337	337
Additional paid-in capital	10,548	11,686
Accumulated deficit	(17,997)	(79,801)
Total stockholders' deficit	(7,099)	(67,757)
Total liabilities and stockholders' deficit	$134,149	$146,971

See accompanying notes.

BIRCH TELECOM, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

YEARS ENDED DECEMBER 31, 1997, 1998 AND 1999

(IN THOUSANDS, EXCEPT PER SHARE DATA)

	1997	1998	1999
Revenue:			
Communications services	$ --	$ 21,783	$ 52,980
Equipment sales	--	4,304	7,558
Total revenue	--	26,087	60,538
Cost of services:			
Cost of communications services	--	16,339	41,870
Cost of equipment sales	--	2,547	4,488
Total cost of services	--	18,886	46,358
Gross margin	--	7,201	14,180
Selling, general and administrative expenses	1,776	15,769	53,045
Depreciation and amortization expense	27	2,308	10,828
Loss from operations	(1,803)	(10,876)	(49,693)
Interest expense	--	(8,254)	(15,036)
Interest income	14	2,922	2,925
Net loss	(1,789)	(16,208)	(61,804)
Preferred stock dividends	--	(1,696)	(3,550)
Amortization of preferred stock issuance costs	--	(29)	(292)
Loss applicable to common stock	$(1,789)	$(17,933)	$(65,646)
Loss per common share--basic and diluted	$ (1.45)	$ (4.71)	$ (13.25)
Weighted average number of common shares outstanding	1,235	3,809	4,956

See accompanying notes.

BIRCH TELECOM, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)
YEARS ENDED DECEMBER 31, 1997, 1998 AND 1999
(IN THOUSANDS)

	SERIES A PREFERRED STOCK	SERIES B PREFERRED STOCK	SERIES C PREFERRED STOCK	SERIES D PREFERRED STOCK	SERIES E PREFERRED STOCK	COMMON STOCK $.01 PAR	WARRANTS $.01 PAR	COMMON STOCK $.001 PAR
Balance at December 23, 1996 (date of inception) and December 31, 1996	$ --	$ --	$ --	$ --	$ --	$ --	$ --	$ --
Issuance of common stock and warrants	--	--	--	--	--	18	18	--
Net loss and comprehensive loss	--	--	--	--	--	--	--	--
Balance at December 31, 1997	--	--	--	--	--	18	18	--
Recapitalization	--	--	2	--	--	(18)	(18)	--
Merger with Valu-Line	3	--	6	--	--	--	--	--
Issuance of warrants in connection with 14% senior notes	--	--	--	--	--	--	--	--
Redemption of series A preferred stock	(3)	--	--	--	--	--	--	--
Stock dividend	--	--	--	--	--	--	--	1
Option exercise	--	--	--	--	--	--	--	4
Restatement of series B preferred stock dividends	--	--	--	--	--	--	--	--
Amortization of series B preferred stock issuance costs	--	--	--	--	--	--	--	--
Series A preferred stock dividends	--	--	--	--	--	--	--	--
Accretion of series B preferred stock dividends	--	--	--	--	--	--	--	--
Net loss and comprehensive loss	--	--	--	--	--	--	--	--
Balance at December 31, 1998	--	--	8	--	--	--	--	5

	WARRANTS $.001 PAR	ADDITIONAL PAID-IN CAPITAL	ACCUMULATED DEFICIT	TOTAL
Balance at December 23, 1996 (date of inception) and December 31, 1996	$--	$ --	$ --	$ --
Issuance of common stock and warrants	--	1,782	--	1,818
Net loss and comprehensive loss	--	--	(1,789)	(1,789)
Balance at December 31, 1997	--	1,782	(1,789)	29
Recapitalization	--	34	--	--
Merger with Valu-Line	--	14,741	--	14,750
Issuance of warrants in connection with 14% senior notes	337	--	--	337
Redemption of series A preferred stock	--	(4,747)	--	(4,750)
Stock dividend	--	(1)	--	--
Option exercise	--	--	--	4
Restatement of series B preferred stock dividends	--	464	--	464
Amortization of series B preferred stock issuance costs	--	(29)	--	(29)
Series A preferred stock dividends	--	(168)	--	(168)
Accretion of series B preferred stock dividends	--	(1,528)	--	(1,528)
Net loss and comprehensive loss	--	--	(16,208)	(16,208)
Balance at December 31, 1998	337	10,548	(17,997)	(7,099)

BIRCH TELECOM, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT) (CONTINUED)
YEARS ENDED DECEMBER 31, 1997, 1998 AND 1999
(IN THOUSANDS)

	SERIES A PREFERRED STOCK	SERIES B PREFERRED STOCK	SERIES C PREFERRED STOCK	SERIES D PREFERRED STOCK	SERIES E PREFERRED STOCK	COMMON STOCK $.01 PAR	WARRANTS $.01 PAR	COMMON STOCK $.001 PAR
Balance at December 31, 1998	$ --	$--	$ 8	$--	$--	$ --	$ --	$ 5
Issuance of series D preferred stock	--	--	--	2	--	--	--	--
Issuance of series E preferred stock	--	--	--	--	2	--	--	--
Issuance of common stock	--	--	--	--	--	--	--	--
Restatement of series B preferred stock	--	8	--	--	--	--	--	--
Redemption of series C preferred stock	--	--	(2)	--	--	--	--	--
Redemption of series E preferred stock	--	--	--	--	(2)	--	--	--
Retirement of common stock	--	--	--	--	--	--	--	--
Amortization of series F preferred stock issuance costs	--	--	--	--	--	--	--	--
Accretion of series F preferred stock dividends	--	--	--	--	--	--	--	--
Net loss and comprehensive loss	--	--	--	--	--	--	--	--
Balance at December 31, 1999	$ --	$ 8	$ 6	$ 2	$--	$ --	$ --	$ 5

	WARRANTS $.001 PAR	ADDITIONAL PAID-IN CAPITAL	ACCUMULATED DEFICIT	TOTAL
Balance at December 31, 1998	$337	$ 10,548	$(17,997)	$ (7,099)
Issuance of series D preferred stock	--	9,998	--	10,000
Issuance of series E preferred stock	--	(2)	--	--
Issuance of common stock	--	211	--	211
Restatement of series B preferred stock	--	13,760	--	13,768
Redemption of series C preferred stock	--	(9,998)	--	(10,000)
Redemption of series E				

preferred stock............	--	(8,570)	--	(8,572)
Retirement of common stock....	--	(449)	--	(449)
Amortization of series F preferred stock issuance costs......................	--	(262)	--	(262)
Accretion of series F preferred stock dividends...	--	(3,550)	--	(3,550)
Net loss and comprehensive loss......................	--	--	(61,804)	(61,804)
Balance at December 31, 1999......................	$337	$ 11,686	$(79,801)	$(67,757)

See accompanying notes.

BIRCH TELECOM, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

YEARS ENDED DECEMBER 31, 1997, 1998 AND 1999

(IN THOUSANDS)

	1997	1998	1999
OPERATING ACTIVITIES			
Net loss..	$(1,789)	$(16,208)	$(61,804)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation..	27	720	7,948
Amortization..	--	1,588	2,880
Provision for losses on accounts receivable..............	--	140	561
Other..	50	16	34
Changes in operating assets and liabilities, net of effects of acquisitions:			
Accounts receivable..................................	--	(1,905)	(7,633)
Inventory..	--	(300)	(989)
Prepaid expenses.....................................	(7)	(370)	(1,907)
Other intangibles....................................	--	--	(2,065)
Other assets...	(87)	(198)	(2,357)
Accounts payable.....................................	255	3,888	4,592
Accrued expenses.....................................	--	1,986	7,515
Net cash used in operating activities....................	(1,551)	(10,643)	(53,225)
INVESTING ACTIVITIES			
Purchase of property and equipment.......................	(128)	(21,550)	(41,360)
Business acquisitions, net of cash acquired..............	--	(7,757)	(4,801)
Amortization of discount on pledged securities...........	--	(1,231)	(1,725)
Maturity of pledged securities...........................	--	7,692	16,100
Purchase of pledged securities...........................	--	(44,247)	(10)
Net cash used in investing activities....................	(128)	(67,093)	(31,796)
FINANCING ACTIVITIES			
Proceeds from long-term debt.............................	--	123	10,000
Proceeds from 14% senior notes...........................	--	114,663	--
Proceeds from convertible notes..........................	--	3,500	--
Proceeds from issuance of preferred stock................	--	9,500	70,000
Proceeds from issuance of common stock and warrants.......	1,768	342	--
Payment of financing costs...............................	(129)	(4,922)	(8,804)
Repayment of long-term debt..............................	--	(321)	(773)
Repayment of capital lease obligations...................	--	(172)	(1,073)
Payment of series A preferred stock dividends............	--	(168)	--
Borrowing (repayment) of notes payable to stockholders....	250	(524)	--
Redemption of preferred stock............................	--	(4,750)	(18,572)
Redemption of common stock...............................	--	--	(449)
Net cash provided by financing activities................	1,889	117,271	50,329
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS........	210	39,535	(34,692)

CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	--	210	39,745
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 210	$ 39,745	$ 5,053
Supplementary schedule of non-cash investing and financing activities:			
Amounts recorded in connection with acquisitions:			
Fair value of net assets acquired, net of cash acquired	$ --	$ 5,064	$ 2,693
Fair value of intangible assets	--	20,900	4,130
Assumption of liabilities	--	(2,430)	(939)
Assumption of long-term debt and capital lease obligations	--	(1,027)	(872)
Issuance of series A preferred stock	--	(4,750)	--
Issuance of series C preferred stock	--	(10,000)	--
Issuance of common stock	--	--	(211)
Common stock issued in exchange for other assets	50	--	--
Property and equipment additions acquired through capital lease	--	728	2,099
Property and equipment additions included in accounts payable	--	2,157	5,873
Supplemental disclosure of cash flow information:			
Cash payment for interest, net of interest capitalized of $436 in 1998 and $1,324 in 1999	--	7,725	13,690

See accompanying notes.

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BIRCH TELECOM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. THE COMPANY

Birch Telecom, Inc. was incorporated on December 23, 1996, as a Delaware corporation for the purpose of providing local, long distance, Internet access, and other communications services to business and residential customers. The consolidated financial statements of Birch Telecom, Inc. include the accounts of Birch Telecom, Inc. and the accounts of its wholly-owned subsidiaries (collectively, Birch). Birch currently serves certain markets in Missouri, Kansas and Texas. Birch's business is highly competitive and is subject to various federal, state and local regulations.

Birch was in the development stage for the period from December 23, 1996 (date of inception) to February 10, 1998. Accordingly, Birch had no operating revenue and incurred operating losses and operating cash flow deficits during that period.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

CASH AND CASH EQUIVALENTS

For purposes of reporting cash flows, Birch includes as cash and cash equivalents highly liquid investments with original maturities of three months or less.

REVENUE RECOGNITION

Revenue for communications services is recognized when customers use the associated services. Equipment revenue is recognized when systems or services are substantially complete. Revenue on billings to customers in advance of providing services is deferred and recognized when earned. Customers are not charged fees to activate initial service.

COST OF SERVICES

Cost of services includes local and long-distance services purchased from incumbent local exchange carriers, interexchange carriers and certain providers of fiber optic telephone networks. Cost of services also includes costs associated with the sale and installation of telephone systems.

INVENTORY

Inventory is carried at the lower of average cost or market determined on a first-in, first-out basis and consists primarily of parts and equipment used in the maintenance and installation of telephone systems.

ADVERTISING COSTS

Advertising costs are expensed as incurred and totaled $895,000 in 1998 and $3.0 million in 1999. There were no advertising costs in 1997.

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BIRCH TELECOM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)
PROPERTY AND EQUIPMENT

Property and equipment is stated at cost and depreciated using the straight-line method over the following estimated useful lives of the assets:

	YEARS
Communications network	2-10
Buildings, furniture, fixtures and equipment	2-40

GOODWILL AND OTHER INTANGIBLES

Goodwill represents the excess of the purchase price paid over the fair value of the net assets acquired in Birch's acquisitions. Goodwill is being amortized over 25 years using the straight-line method. Accumulated amortization on goodwill totaled $599,000 at December 31, 1998 and $1.4 million at December 31, 1999.

Other intangibles consist primarily of customer lists related to Birch's acquisitions, deferred financing costs and deferred line installation costs. Customer lists are amortized over 5 years using the straight-line method. The deferred financing costs are amortized over 5 to 10 years, the term of the associated financing, using the straight-line method. Deferred line installation costs are being amortized over 2 years, the approximate average life of customer contracts, using the straight-line method (see Note 6).

Birch reviews its long-lived assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 121, "Accounting for the Impairment of Long-lived Assets and Long-lived Assets to be Disposed of," for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If such events or changes in circumstances are present, a loss is recognized if the carrying value of the asset is in excess of the sum of the undiscounted cash flows expected to result from the use of the asset and its eventual disposition. An impairment loss is measured as the amount by which the carrying amount of the asset exceeds the fair value of the asset.

INCOME TAXES

Birch accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes. Birch recognizes deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the differences between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Net deferred tax assets are reduced by a valuation allowance when appropriate (see Note 14). Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

STOCK OPTIONS

Birch has adopted the disclosure provisions of SFAS No. 123, Accounting for Stock-Based Compensation, which establishes a fair value based method for the financial reporting of its stock-based employee compensation plans. However, as allowed by SFAS No. 123, Birch has elected to continue to measure compensation using the intrinsic value based method as prescribed by Accounting Principles

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BIRCH TELECOM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Board Opinion No. 25, Accounting for Stock Issued to Employees. Under this method, compensation is measured as the difference between the market value of the stock on the grant date, less the amount required to be paid for the stock. The difference, if any, is charged to expense over the vesting period of the options. The estimated market value used for the stock options granted was determined on a periodic basis by Birch's board of directors. In accordance with APB No. 25, Birch has recorded no compensation expense related to options granted because the exercise price is equal to the estimated market value of the stock on the date of grant (see Note 15).

FAIR VALUES OF FINANCIAL INSTRUMENTS

The carrying amount of cash and cash equivalents approximates fair value due to the short maturity of the instruments. The fair value of Birch's pledged securities was $38 million at December 31, 1998 and $23.3 million at December 31, 1999. The fair value of Birch's senior notes is estimated to be $106 million at December 31, 1998 and $115 million at December 31, 1999 based on the quoted market rates for the debt. The fair value of other long-term debt, accounts receivable, accounts payable and accrued expenses approximates the recorded value.

USE OF ESTIMATES IN FINANCIAL STATEMENTS

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

LOSS PER SHARE

The net loss per share amount reflected on the consolidated statement of operations is based on the weighted-average number of common shares outstanding. Stock options and convertible preferred stock are anti-dilutive, and therefore excluded from the computation of earnings per share. In the future, these stock equivalents may become dilutive.

RECLASSIFICATIONS

Certain items in the 1997 and 1998 consolidated financial statements have been reclassified to be consistent with the classification in the 1999 consolidated financial statements.

NEW ACCOUNTING PRONOUNCEMENTS

In June 1998, the Financial Accounting Standards Board (FASB) issued SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, which supersedes SFAS No. 80, Accounting for Futures Contracts, SFAS No. 105, Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentration of Credit Risk, and SFAS No. 119, Disclosures about Derivative Financial Instruments and Fair Value of Financial Instruments, and also amends certain aspects of other SFAS's previously issued. SFAS No. 133 establishes accounting and reporting standards for derivative instruments and hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the balance sheet and measure those instruments at fair value. SFAS No. 133 is effective for our consolidated financial statements for the

year ending December 31, 2001. We do not expect the impact of SFAS No. 133 to be material in relation to its consolidated financial statements.

3. ACQUISITIONS

In February 1998, Birch merged with Valu-Line Companies, Inc. (Valu-Line) in a transaction valued at $19.5 million, consisting of $4.75 million in cash, 2,968,750 shares of series A preferred stock having an aggregate liquidation preference of $4.75 million and 6,250,000 shares of series C preferred stock having an aggregate liquidation preference of $10.0 million. Since 1982, Valu-Line has been primarily providing switched long distance services, customer premises equipment (CPE) sales and services and, since March 1997, local service.

In May 1998, Birch acquired Boulevard Phone Company (Boulevard), a shared tenant service provider in the Kansas City metropolitan area, for $300,000 in cash and Telesource Communications, Inc. (Telesource), a CPE provider in the Kansas City metropolitan area, for $325,000 in cash.

In September 1998, Birch acquired TFSnet, Inc. (TFSnet), an Internet service provider based in the Kansas City metropolitan area, for $2.65 million.

In February 1999, Birch acquired American Local Telecommunications, LLC (ALT), a competitive local exchange carrier based in the Dallas, Texas metropolitan area. The acquisition included substantially all assets of ALT. The total purchase price was approximately $1.6 million in cash and $211,000 in common stock.

In March 1999, Birch acquired the stock of Capital Communications Corporation (Capital), a telecommunications equipment provider based in the St. Louis, Missouri metropolitan area. The total purchase price was approximately $3.0 million plus additional cash consideration, recorded as additional purchase price, based on local service lines converted to Birch's service from Capital's existing customer base, which totaled approximately $161,000 through December 31, 1999.

All of the acquisitions referenced above were recorded using the purchase method of accounting. Accordingly, the operations of each are included in the consolidated statements of operations and cash flows from the date of acquisition.

The following is unaudited pro forma information reflecting the effect of the 1998 acquisitions on the results as though they had been completed effective January 1, 1997 and 1998:

	YEARS ENDED DECEMBER 31, 1997	1998
	(IN THOUSANDS, EXCEPT PER SHARE DATA)	
Revenue	$18,847	$29,193
Net loss	19,325	28,921
Loss per common share	15.65	8.05

The impact of the 1999 acquisitions was not material to our results of operations.

4. ACCOUNTS RECEIVABLE

The composition of accounts receivable, net as of December 31, 1998 and 1999 is as follows:

	1998	1999
	(IN THOUSANDS)	
Billed	$3,144	$ 9,312
Unbilled	1,129	2,756
	4,273	12,068
Less allowance for doubtful accounts	234	456
	$4,039	$11,612

5. PROPERTY AND EQUIPMENT

The composition of property and equipment as of December 31, 1998 and 1999 is as follows:

	1998	1999
	(IN THOUSANDS)	
Communications network	$ 5,966	$28,525
Buildings, furniture, fixtures and equipment	6,529	38,662
Construction in progress	14,405	3,005
	26,900	70,192
Less accumulated depreciation and amortization	747	8,080
Property and equipment, net	$26,153	$62,112

6. OTHER INTANGIBLES

The composition of other intangible assets, net as of December 31, 1998 and 1999 is as follows:

	1998	1999
	(IN THOUSANDS)	
Customer lists	$3,525	$ 4,225
Preferred stock issuance costs	325	6,989
Deferred financing costs	4,630	6,412
Deferred installation costs	--	2,363
Other	153	330
	8,633	20,319
Less accumulated amortization	1,013	3,408
Other intangibles, net	$7,620	$16,911

7. DEBT, PLEDGED SECURITIES AND WARRANTS

During December 1999, Birch completed a $75 million senior credit facility which increased to $125 million during syndication in February 2000. The financing provides for a $25 million reducing revolver and $100 million in multi-draw term loans. The revolver is available for general corporate

7. DEBT, PLEDGED SECURITIES AND WARRANTS (CONTINUED)

purposes of Birch's subsidiaries and the term loans are to be used to finance the development, design, installation and acquisition of telecommunications equipment, inventory network assets and back office systems. At Birch's election, the borrowings bear interest at either the Prime Rate plus a margin ranging from 1.50% to 2.50% or the London Interbank Offered Rate (LIBOR) plus a margin ranging from 2.75% to 3.75%. The applicable margins are based upon Birch's debt to EBITDA ratio, as defined by the senior credit facility. Interest is paid quarterly in arrears for loans bearing interest based upon Prime and/or on the last day of each relevant interest period, for periods not in excess of three months, for LIBOR loans. For LIBOR loans with interest periods of longer than three months, interest is paid each day which is three months after the first day of such interest period and the last day of such interest period. Commitment fees are paid quarterly in arrears on the average unused committed portion of the Facility, ranging from 0.75% to 1.25%. The applicable percentages are based upon Birch's average borrowings in relation to the average borrowing availability, as defined by the senior credit facility. For the year ended December 31, 1999 commitment fees totaled $25,174. Principal payments begin March 2003 and the credit facility matures December 30, 2006. The senior credit facility is secured by a perfected first priority security interest in substantially all of Birch's assets and capital stock. Deferred financing costs incurred amounting to $1.5 million at December 31, 1999 are being amortized over the life of the credit facility using the straight-line method. Amortization for the year ended December 31, 1999 was not significant.

During June 1998, Birch completed a $115 million private offering of 14% senior notes due June 2008 and 115,000 warrants to purchase 1,409,734 shares of common stock. Interest on the senior notes is payable semi-annually in arrears on June 15 and December 15 of each year. Warrants are exercisable at $0.01 per share and expire June 2008. Birch received net proceeds from the senior notes of $110.2 million and concurrently purchased pledged securities of $44.2 million. The pledged securities are restricted for interest payments on the senior notes and, together with the interest accruing thereon, will be used to satisfy such interest payments through June 2001. Birch classifies its pledged securities, consisting of $37.8 million at December 31, 1998 and $23.4 million at December 31, 1999 of U.S. Treasury securities, as held to maturity recorded at amortized cost and maturing between six and eighteen months. A portion of the proceeds from the senior notes, $337,000, was allocated to the warrants, and the resulting debt discount is being amortized over the life of the debt on the straight-line method, which does not differ materially from the effective interest method. Unamortized discount was $319,000 at December 31, 1998 and $285,000 at December 31, 1999. The amount allocated to the warrants represents the estimated fair value of the warrants at the date of issuance. Deferred financing costs incurred amounting to $4.9 million at December 31, 1999 are being amortized over the life of the senior notes using the straight-line method. Accumulated amortization on the financing costs totaled $1.5 million at December 31, 1999. The senior notes rank pari pasu in right of payment to all existing and future senior indebtedness of Birch and rank senior in the right of payment to all existing and future subordinated indebtedness of Birch.

A Registration Statement on Form S-4, registering Birch's 14% senior notes and exchanging the outstanding senior notes for exchange notes, was declared effective by the Securities and Exchange Commission (SEC) in March 1999. The terms and conditions of the exchange notes are identical to those of the senior notes in all material respects.

The senior credit facility and the senior notes indenture contain certain covenants which, among other things, restrict the ability of Birch to incur additional indebtedness, pay dividends or make

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BIRCH TELECOM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

7. DEBT, PLEDGED SECURITIES AND WARRANTS (CONTINUED)
distributions of Birch's or its subsidiaries' stock, enter into sale and leaseback transactions, create liens, enter into transactions with affiliates or related persons, consolidate, merge or sell all of its assets. Birch was in compliance with these covenants at December 31, 1999.

Birch's debt consisted of the following at December 31, 1998 and 1999:

	1998	1999
	(IN THOUSANDS)	
14% senior notes	$114,681	$114,715
Senior credit facility:		
Equipment term loans	$ --	$ 10,000
Total senior credit facility	$ --	$ 10,000
Other long-term debt, interest accruing between 8.6% and 9.8%, maturing through 2013, secured by buildings	$ 345	$ 244
Less current maturities	13	10
	$ 332	$ 234

Assets securing the other long-term debt totaled $814,000 at December 31, 1998 and $766,237 at December 31, 1999, net of accumulated depreciation of $19,000 at December 31, 1998 and $35,037 at December 31, 1999.

Principal payments required on the outstanding debt during each of the next five years are as follows (IN THOUSANDS):

2000	$ 10
2001	10
2002	11
2003	5,012
2004	5,014
Thereafter	114,902
	$ 124,959

8. CAPITAL LEASE OBLIGATIONS

Birch leases telecommunications equipment, computer equipment and automobiles under capital leases with imputed interest between 8.0% and 12.0%. Assets under capital leases totaled $1.5 million at December 31, 1998 and $3.6 million at December 31, 1999, net of accumulated amortization of $210,000 at December 31, 1998 and $1.1 million at December 31, 1999. The future minimum lease

8. CAPITAL LEASE OBLIGATIONS (CONTINUED)
payments under the capital leases and the present value of the net minimum lease payments as of December 31, 1999 are as follows (IN THOUSANDS':

2000	$1,528
2001	545
2002	92
2003	57
2004	--
Total minimum lease payments	2,222
Less amount representing interest	96
Present value of net minimum lease payments	2,126
Less current maturities	1,290
	$ 836

Amortization expense for assets under capital leases was $157,000 for 1998 and $974,165 for 1999.

9. CAPITAL STRUCTURE

During 1997, $1.8 million of common stock and $18,000 of warrants were sold to management and equity investors for $1.00 and $0.01 per share, respectively.

The warrants entitled the holders to purchase an additional 1.8 million shares of common stock at $1.00 per share.

During February and March 1998, Birch issued $9.5 million of series B preferred stock at $4.50 per share and $3.5 million of convertible notes generating net proceeds of $12.4 million, converted all existing common stock to series C preferred stock, terminated common stock warrants, canceled the 1997 stock option plan, created the 1998 stock option plan and issued 474,750 shares of common stock to employees of Birch. Also during February 1998, Birch issued $4.75 million of series A preferred stock and $10.0 million of series C preferred stock in connection with the Valu-Line merger. Birch redeemed the series A preferred stock in June 1998. Also in June 1998, the convertible notes were converted into series B preferred stock.

During July and August 1999, Birch issued $10 million of series D preferred stock and $60 million of series F preferred stock at $4.50 per share. Options were granted to purchase $25 million of series F preferred stock at $4.75 per share and $25 million of series F preferred stock at $5.00 per share which expire on April 13, 2000. Additionally, Birch repurchased $10 million of series C preferred stock at $4.50 and recapitalized the series B preferred stock converting it into a new series B preferred stock and a new series E preferred stock. The series E preferred stock was then redeemed for $8.6 million. Net proceeds generated from these transactions totaled $44.4 million.

AUTHORIZED SHARES

At December 31, 1999, Birch had shares authorized totaling 80 million shares of common stock and 55 million shares of preferred stock. The preferred stock has designations of 8.75 million shares of series B, 8.5 million shares of series C, 2.2 million shares of series D, 1.9 million shares of series E and 30 million shares of series F.

9. CAPITAL STRUCTURE (CONTINUED)
RIGHTS

All classes of preferred stock are convertible and contain certain voting rights. The common stock also has voting rights similar to the series C preferred stock. The series B, series D and series F preferred stock have additional voting rights in certain circumstances. Additionally, the series F preferred stock contains mandatory redemption rights based on certain senior management retention. In the event of mandatory redemption, the shares are redeemable for amounts similar to the liquidation preference discussed below.

LIQUIDATION RIGHTS

Birch's series D and series F preferred stock have a liquidation preference over the series B and series C preferred stock and common stock at the greater of (i) the purchase price plus accrued but unpaid dividends or (ii) the amount the holders would have received upon liquidation if such shares of series D and series F preferred stock had been converted to common stock immediately prior to liquidation. Birch's series B preferred stock has a liquidation preference only over series C preferred stock and common stock at an amount equal to the sum of the purchase price plus accrued but unpaid dividends. Series C preferred stock has preference only over common stock at an amount equal to the sum of the purchase price plus accrued but unpaid dividends.

DIVIDENDS

The series B preferred stock accrued cumulative compounding dividends at 15% per annum until the series B was converted and restated into new series B. At that time, the rights and preferences were amended and restated to remove the mandatory dividend rights and now the series B cumulates cash dividends at 15% per annum, amounting to $814,000 at December 31, 1999. The series C preferred stock has a 10% non-cumulative cash dividend and the series D preferred stock cumulates cash dividends at a rate of 15% per annum, totaling $750,000 at December 31, 1999. Only the series F preferred stock contains mandatory dividend rights. Accrued cash dividends on series F preferred stock totaled $3.6 million at December 31, 1999, as reflected in stockholders' equity. Common stock dividends, if any, will be declared at the discretion of Birch's board of directors. Birch has not paid any cash dividends on common stock since inception and does not intend to pay any in the foreseeable future. Restrictions contained in the senior credit facility agreement and the senior notes indenture prohibit Birch from paying certain dividends on its capital stock.

On June 23, 1998, Birch paid a stock dividend, in the amount of 0.055 shares per share, to the holders of Birch's series B preferred stock, series C preferred stock and common stock as of June 15, 1998. Dividends paid on series A preferred stock in 1998 totaled $168,000.

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BIRCH TELECOM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

10. RELATED-PARTY TRANSACTIONS

During December 1997, Birch borrowed $250,000 from Birch's principal stockholder under a note payable. The note payable was fully repaid in February 1998.

Birch acquired notes payable to Valu-Line shareholders totaling $274,000 in the Valu-Line merger. These notes were fully repaid during 1998.

A broadcasting company owned by one of the Birch's shareholders rented office space from Birch for $30,000 during 1998 and $29,187 during 1999. Birch purchased advertising from the broadcasting company totaling $40,000 in 1998 and $30,360 in 1999.

A real estate company owned by the President of Birch's equipment division was paid $3,588 for building maintenance in 1998 and $12,587 in 1999.

11. COMMITMENTS AND CONTINGENCIES

Future minimum rental commitments at December 31, 1999 for all noncancelable operating leases, consisting mainly of leases for office space and equipment, are as follows (IN THOUSANDS):

2000	$ 2,766,794
2001	3,042,829
2002	2,925,940
2003	2,567,295
2004	2,443,322
Thereafter	7,769,655
Total	$21,515,835

Total rent expense was $81,000 in 1997, $485,000 in 1998 and $1.5 million in 1999. Birch may renew leases on its corporate offices in terms ranging from three to ten years at rates approximating the prevailing market. Renewal rentals are excluded from the table.

Various suits arising in the ordinary course of business are pending against

Birch. Management cannot predict the final outcome of the actions, but believes they will not be material to Birch's financial statements.

12. EMPLOYEE BENEFIT PLAN

Birch sponsors a 401(k) profit-sharing plan covering substantially all employees under which employees can contribute up to 15% of their annual salary subject to annual maximum limitations. Employees can participate after meeting the plan's eligibility requirements. Birch may also make discretionary contributions. Birch contributions to the plan were $148,000 in 1998 and $594,925 in 1999.

13. EMPLOYMENT AGREEMENTS

Birch has entered into employment agreements with certain executive employees which provide for payments to be made in connection with certain termination of employment or change of control. The benefits include cash compensation, immediate vesting of outstanding stock options and coverage under Birch's group health plan.

14. INCOME TAXES

Net deferred taxes consist of the following as of December 31, 1998 and 1999:

	1998	1999
	(IN THOUSANDS)	
Deferred tax assets:		
Net operating loss carryforwards	$ 5,528	$ 28,770
Accruals and reserves not currently deductible	91	182
Other	668	614
	6,287	29,566
Valuation allowance	(5,799)	(28,741)
	488	825
Deferred tax liabilities:		
Property and equipment	488	825
	$ --	$ --

Net income tax benefits of approximately $5.1 million in 1998 and $22.9 in 1999 have been offset by increases in the valuation allowance. At December 31, 1999, Birch had operating loss carryforwards for federal income tax purposes of approximately $71.9 million, expiring in 2013 and 2014.

The primary difference that caused the effective tax rate to vary from the statutory federal income tax rate of 35% was the valuation allowance.

15. STOCK OPTION PLAN

At December 31, 1997, Birch had granted options to purchase common stock under the 1997 stock option plan. The options granted had a term of 10 years and vested over a four-year period. This plan was terminated and superseded in 1998 by the 1998 employee stock option plan. No options were or ever will be exercised and no shares were or will ever be issued under the terminated and superseded 1997 stock option plan.

Stock option activity under the 1997 stock option plan was as follows:

	SHARES	WEIGHTED-AVERAGE PER SHARE EXERCISE PRICE
Granted	2,783,000	$ 1.00
Exercised	--	--
Forfeited	--	--
Outstanding at December 31, 1997	2,783,000	1.00
Terminated	(2,783,000)	1.00
Outstanding at December 31, 1998	--	--

15. STOCK OPTION PLAN (CONTINUED)

Stock option activity under the 1998 employee stock option plan was as follows:

	SHARES	WEIGHTED-AVERAGE PER SHARE EXERCISE PRICE
Granted	5,093,064	$0.242
Exercised	4,566,889	0.001
Forfeited	14,250	2.500
Outstanding at December 31, 1998	511,925	2.334
Granted	1,794,800	3.845
Exercised	--	--
Forfeited	275,875	3.038
Outstanding at December 31, 1999	2,030,850	3.574

At December 31, 1998, 5,363 options were exercisable with a weighted average exercise price of $0.001. At December 31, 1999, 107,468 options were exercisable with a weighted average exercise price of $2.175.

The 1998 employee stock option plan authorized the grant of options for up to 6,195,845 shares of Birch's common stock. The options have a term of 10 years and vest over a four-year period. All options exercised during 1998 were for options granted with an early exercise provision. The shares from exercised options continue to be subject to the four-year vesting period. No options expired during 1998 or 1999.

Options granted in 1998 and 1999 had exercise prices approximating the market value of the common stock. Exercise prices for options outstanding at December 31, 1999 ranged from $0.001 to $4.50. The weighted-average remaining contractual life of those options is 9.4 years. The weighted-average fair values of options granted during the years ended December 31, 1998 and 1999 equaled $0.05 and $0.73, respectively. At December 31, 1999, Birch has reserved 1,628,956 shares of common stock for issuance under the 1998 stock option plan.

Birch estimated the fair value of each option grant using the minimum value method permitted by SFAS No. 123 for entities not publicly traded. Birch used the following assumptions in the calculation: risk-free interest rate of 5.25%, expected life of four years and no dividends being paid over the life of the options. Under the minimum value method, the volatility factor is excluded. Had compensation cost for the stock based compensation plan been determined as prescribed by SFAS No. 123, the net loss and loss per common share would have been as follows for the years ended December 31, 1997, 1998 and 1999:

	1997	1998	1999
	(IN THOUSANDS, EXCEPT PER SHARE DATA)		
Net loss--as reported	$(1,789)	$(16,208)	$(61,804)
Net loss--pro forma	(1,921)	(16,384)	(62,411)
Loss per share--Basic and Diluted--Pro Forma	(1.56)	(4.75)	(13.36)

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BIRCH TELECOM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

16. SIGNIFICANT SUPPLIERS

Birch purchased telephone services from Southwestern Bell Telephone amounting to 35% of cost of services in 1998 and 65% in 1999. Birch is dependent upon incumbent telephone companies, such as Southwestern Bell, for the supply of fiber optic networks that we use. Birch purchased switches and other network equipment and software from Lucent Technologies amounting to $12.9 million in 1998 and $9.9 million in 1999.

17. YEAR 2000 ISSUE--UNAUDITED

The Year 2000 issue is the result of computer programs being written using two digits rather than four to define the applicable year. Any of Birch's computer programs that have date-sensitive software may recognize the date using "00" as the year 1900 rather than the year 2000. Birch completed all Year 2000 readiness work and experienced no significant problems as a result of the new year. Birch does not believe it has continued exposure to the Year 2000 problem and does not expect further costs incurred in relation to the Year 2000 issue to be substantial.

18. QUARTERLY DATA--UNAUDITED

The following table includes summarized quarterly financial data for the years ended December 31:

QUARTERS

	FIRST	SECOND	THIRD	FOURTH
	(IN THOUSANDS, EXCEPT PER SHARE DATA)			
1998:				
Revenue	$ 3,705	$ 6,060	$ 7,478	$ 8,844
Gross margin	1,063	1,628	2,305	2,205
Loss from operations	(567)	(1,486)	(2,996)	(5,827)
Net loss	(623)	(1,766)	(5,468)	(8,351)
Loss per common share--basic and diluted	(0.79)	(0.55)	(1.19)	(1.76)
1999:				
Revenue	$10,636	$ 13,975	$ 17,022	$ 18,905
Gross margin	2,711	3,574	3,753	4,142
Loss from operations	(7,128)	(9,525)	(13,710)	(19,330)
Net loss	(9,936)	(12,639)	(16,690)	(22,539)
Loss per common share--basic and diluted	(2.06)	(2.59)	(3.43)	(5.30)

19. SUBSEQUENT EVENTS

Since December 31, 1999, Birch has borrowed an additional $40 million through March 23, 2000 under the term loan portion of the senior credit facility.

On March 23, 2000 an affiliate of Kohlberg Kravis Roberts & Co. exercised its options to purchase an additional $50.0 million of Birch's series F preferred stock (see note 9).

Also on March 23, 2000, Birch filed a registration statement on Form S-1 relating to a proposed initial public offering of its common stock. All outstanding shares of Birch's preferred stock will automatically convert into shares of common stock upon completion of the proposed offering. In addition Birch expects to declare a 1.795 for 1 split of its common stock prior to completion of the offering. The conversion ratio for the preferred stock will be adjusted accordingly.

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REPORT OF INDEPENDENT AUDITORS

The Board of Directors
Valu-Line Companies, Inc.

We have audited the accompanying consolidated balance sheet of the Valu-Line Companies, Inc. (the Company) as of December 31, 1997, and the related consolidated statements of income and retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Valu-Line Companies, Inc. at December 31, 1997 and the consolidated results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States.

Ernst & Young LLP

Kansas City, Missouri

May 15, 1998

VALU-LINE COMPANIES, INC.

CONSOLIDATED BALANCE SHEET

DECEMBER 31, 1997

(IN THOUSANDS, EXCEPT SHARE DATA)

ASSETS	
Current assets:	
Cash and cash equivalents	$ 258
Accounts receivable, net of allowance of $70	1,790
Other receivables--related parties	97
Inventories	530
Prepaid expenses	37
Income taxes receivable	30
Other assets	60
Deferred income taxes	71
Total current assets	2,873
Property and equipment, net	1,612
Other assets	317
Total assets	$4,802
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities:	
Current maturities of long-term debt and capital lease obligation	$ 110
Notes payable--related parties	240
Accounts payable	1,262
Accrued expenses	225
Customer deposits	39
Accrued salaries and commissions	266
Deferred revenue	287
Total current liabilities	2,429
Long-term debt, net of current maturities	345
Capital lease obligation, net of current maturities	336
Deferred income taxes	27
STOCKHOLDERS' EQUITY	
Common stock, no par value, 100,000 shares authorized; 10,360 issued and outstanding	181
Retained earnings	1,484
Total stockholders' equity	1,665
Total liabilities and stockholders' equity	$4,802

See accompanying notes.

VALU-LINE COMPANIES, INC.